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Overcoming obstacles for U.S. and foreign investment partnerships

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In recent years, there has been an influx of foreign investment in U.S. assets including real estate. The Chamber of Commerce says that there is now a total of over $3 trillion in American business assets owned by foreign entities. The rise of foreign dollars has been great for economic growth generating over 5.5 million American jobs.

Increasingly, foreign investors are targeting major American cities for real estate investment because of their popularity and relative stability, and Boston is among the most popular of these cities. Boston's reputation for elite schools such as MIT and Harvard, its major appeal for up and coming professionals, and great historic significance make the city ripe for foreign real estate investment.

In addition to popularity and stability, developers and real estate experts provide local support and knowledge to foreign investors in exchange for ease of access to foreign capital. While there are many benefits in partnering up there are also some complications that need consideration before establishing a legal partnership or signing a purchase and sale document. One of the more important complexities is withholding on income.

Withholdings: A Significant Challenge to Foreign Investments

One of the biggest obstacles to foreign investments is withholdings. The responsibility to understand withholdings falls upon the shoulders of the U.S.-based partnership: if foreign ownership is present, the partnership must present a form W-8 BEN or W-8IMY to the foreign partner, to determine if withholding must be done on the foreign partner's income. Withholding is done on a Form 1042 for fixed and determinable income (certain interest and dividends) and Forms 8805 and 8805 for Effectively Connected Income (rental income or income from a trade or business). Withholding is typically at a 30% rate, however, tax advisors for the U.S. partnership can review potential exemptions and reduced rates that may apply to partners in certain foreign countries with which the U.S. has a treaty.

Withholdings can make the specific details of foreign investments tricky. For example, say there is an equal 50-50 investment partnership, with one foreign partner and one U.S. partner that made $100,000 in rental income (50,000 to each partner) and the withholding rate was 30%. The partnership would have to withhold $15,000 on behalf of the foreign partner. The U.S. partner will argue that the partnership should not be on the hook for that $15,000 since the U.S. tax is a liability of the foreign partner and not the partnership.

As a solution, the partnership could decide to reduce future or current distributions to the foreign partner. This works well when the entity was already planning on making distribution payments because there is no requirement for the partner to pass cash back and forth with the partnership.

This does not work well if the entity has income, but no cash to be distributed. Alternatively, the partnership could make the decision to require repayment and issue a short-term loan to the foreign partner, which would allow the partnership to access the $15,000 that was withheld, assuming the loan is repaid in a timely manner. This option does bring with it some additional administrative requirements, which is important to know for reporting and documenting purposes.

There is also the option to do some hybrid of these two solutions, but in hybrid situations it is best to ensure that both parties can provide input on the terms so that the agreement works for everyone.

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